

Message Text

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ACTION EUR-12

INFO OCT-01 EA-07 ISO-00 EURE-00 ABF-01 FS-01 AID-05

CIAE-00 COME-00 EB-07 FRB-03 INR-07 NSAE-00 USIA-06

TRSE-00 XMB-02 OPIC-03 SP-02 CIEP-01 LAB-04 SIL-01

OMB-01 NSC-05 SS-15 STR-04 CEA-01 L-03 H-02 PRS-01

PA-01 AGR-05 /101 W

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P R 271500Z JAN 76

FM AMEMBASSY ROME

TO SECSTATE WASHDC PRIORITY 5363

INFO AMEMBASSY BERN

AMEMBASSY BONN

AMEMBASSY BRUSSELS

USMISSION EC BRUSSELS

AMEMBASSY LONDON

AMEMBASSY OTTAWA

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AMEMBASSY TOKYO

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PASS TREASURY AND FRB

E.O. 11652: N/A

TAGS: EFIN, IT

SUBJECT: COMMENTARY ON LIRA EXCHANGE RATE CRISIS

SUMMARY. AS OF JANUARY 26 LIRA EXCHANGE RATE HAD DEPRECIATED
ABOUT 6.6 PERCENT AGAINST DOLLAR SINCE JANUARY 20, I.E., DAY
BEFORE BANK OF ITALY WITHDREW FROM EXCHANGE MARKET. ITALIAN
PRESS HAS CORRECTLY LISTED CAUSES OF PRESENT EXCHANGE RATE
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PROBLEM AS INCREASE IN IMPORTS, ADVERSE LEADS AND LAGS, AND

CAPITAL FLIGHT DUE TO CURRENT POLITICAL CRISIS. DOUBTS ABOUT ITALY'S FOREIGN CREDITWORTHINESS HAVE ALSO BEEN CITED AS RESULT OF PRESS REPORTS OF ALLEGED POSITION TAKEN BY U.S. COMPTROLLER OF THE CURRENCY RE U.S. BANKS' LENDING TO ITALY. IN LONGER TERM, LARGE BUDGET DEFICIT AND CONTINUED SHARP RISE IN LABOR COSTS HAVE BEEN IDENTIFIED AS ADDITIONAL CAUSES OF LIRE WEAKNESS. PUBLIC SEEMS TO EXPECT RE-ENTRY OF BANK OF ITALY INTO EXCHANGE MARKET RATHER SOON. EMBASSY DOUBTS THAT BOI WILL RE-ENTER MARKET FOR SOME WEEKS. TO MAKE EVENTUAL RESUMPTION OF BOI MARKET INTERVENTION CREDIBLE, THREE FACTORS WILL BE REQUIRED: RESOLUTION IN SOME MANNER OF POLITICAL CRISIS SO THAT AN ITALIAN GOVERNMENT CAN MAKE INTERNATIONAL ECONOMIC COMMITMENTS, AGREEMENT ON CONTENT OF ECONOMIC PROGRAM AND AVAILABILITY OF FOREIGN FINANCING. END SUMMARY.

1. EQUILIBRIUM OF EXCHANGE RATE. AS OF JANUARY 26 LIRA/DOLLAR EXCHANGE RATE WAS ABOUT 732 LIRE PER DOLLAR, REPRESENTING A DEPRECIATION OF LIRA OF 6.6 PERCENT FROM OFFICIAL RATE ON JANUARY 20, DAY BEFORE BOI WITHDREW FROM MARKET. WEIGHTED AVERAGE DEPRECIATION OF LIRA AGAINST ALL CURRENCIES INCREASED FROM 21.01 PERCENT TO 25.82 PERCENT IN SAME PERIOD. ITALIAN PRESS AND EXCHANGE MARKET DEALERS ARE DEBATING WHETHER LIRA WILL STABILIZE AROUND PRESENT LEVEL OR WHETHER IT WILL DEPRECIATE FURTHER, TO AS MUCH AS 15 PERCENT FROM LEVEL WHICH PREVAILED BEFORE BOI WITHDREW FROM MARKET.

2. EMBASSY BELIEVES THAT LIRA WILL DEPRECIATE IN RANGE OF 5 TO 10 PERCENT BELOW PRE-CRISIS LEVEL, BUT DOUBTS THAT IT WILL GO BEYOND THAT. LIRA WOULD LIKELY HAVE DEPRECIATED AT LEAST 5 PERCENT DURING COURSE OF 1976 AS RESULT OF CONTINUED EXCESS OF ITALIAN PRICE AND COST INCREASES OVER THOSE GENERALLY PREVAILING IN COMPETITOR COUNTRIES. JANUARY LIRA CRISIS, TRIGGERED MAINLY BY FALL OF GOVERNMENT, HAS PROBABLY ACCELERATED TIMING OF DEPRECIATION AND PERHAPS ADDED SOMEWHAT TO AMOUNT OF DEPRECIATION WHICH WOULD OTHERWISE HAVE TAKEN PLACE. IN PARTICULAR, IF CAPITAL ACCOUNT SHOWS LARGER-THAN-EXPECTED DEFICIT THIS YEAR DUE TO CAPITAL FLIGHT MOTIVATED BY POLITICAL REASONS, THEN LIRA WILL HAVE TO LIMITED OFFICIAL USE

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DEPRECIATE MORE IN ORDER TO STRENGTHEN CURRENT ACCOUNT POSITION SUFFICIENTLY TO OFFSET INCREASED CAPITAL OUTFLOWS.

3. CAUSES OF CRISIS. IN ITALIAN PRESS IMMEDIATE CAUSES OF LIRA CRISIS HAVE BEEN LISTED AS INCREASE IN IMPORTS IN NOVEMBER AND DECEMBER 1975 DUE TO INVENTORY REBUILDING, ADVERSE LEADS AND LAGS ON CURRENT ACCOUNT

PAYMENTS, AND CAPITAL FLIGHT IN JANUARY FOLLOWING FALL OF GOVERNMENT. OVERALL BALANCE OF PAYMENTS DEFICITS IN NOVEMBER AND DECEMBER WERE LARGER THAN EXPECTED, AT ABOUT \$557 MILLION AND \$489 MILLION, RESPECTIVELY. AVAILABLE BALANCE OF PAYMENTS DATA ARE STILL INSUFFICIENT TO CLEARLY IDENTIFY CAUSES. IT IS TRUE THAT IMPORTS HAVE GRADUALLY BEEN RISING SINCE ABOUT FEBRUARY 1975, AND PRELIMINARY TRADE DEFICIT FIGURES FOR NOVEMBER ON BOTH CUSTOMS AND PAYMENTS BASIS DO SHOW FAIRLY LARGE DEFICIT. LARGE OVERALL DEFICITS IN TWO-MONTH PERIOD MAY HAVE BEEN PARTLY DUE TO SEASONAL FACTORS, AS SERVICES INCOME WAS PROBABLY RATHER LOW AND IMPORTS RATHER HIGH. FALL OF GOVERNMENT NO DOUBT LED TO ACCELERATED PAYMENTS FOR IMPORTS, DELAYED RECEIPTS FOR EXPORTS AND HIDDEN CAPITAL FLIGHT.

4. PUBLICITY REGARDING SUPPOSED CRITICISM BY COMPTROLLER OF THE CURRENCY OF U.S. BANKS' LOANS TO ITALY HAS ALSO BEEN CITED AS CAUSE OF LIRE CRISIS. THIS COULD, IN FACT, HAVE BEEN A CONTRIBUTING FACTOR TO THE EXTENT THAT THESE REPORTS RAISED QUESTIONS ABOUT ITALY'S ABILITY TO OBTAIN NEW EUROMARKET FINANCING IN 1976 AND TO THE EXTENT THAT ITALIANS BELIEVED THAT SOME U.S. BANKS MIGHT HAVE TO ASK FOR EARLY REPAYMENT OF EXISTING EUROLANS IN ORDER FOR BANKS TO GET BACK WITHIN CEILING FOR LOANS TO INDIVIDUAL BORROWERS.

5. ITALIAN COMMENTATORS HAVE ALSO POINTED OUT THAT VERY LIQUID POSITION OF ITALIAN BANKS AS A RESULT OF BOI EASY MONEY POLICIES IN RECENT MONTHS (DESIGNED TO ENCOURAGE ECONOMIC RECOVERY) ALSO PROVIDED AMPLE LIQUIDITY TO FINANCE CAPITAL OUTFLOWS WHEN POLITICAL CRISIS OCCURRED.

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6. EVENTUAL RE-ENTRY OF BOI INTO EXCHANGE MARKET. DESPITE NEARLY THREE YEARS OF A SUPPOSEDLY FLOATING LIRA, EXCHANGE MARKET OPERATORS OBVIOUSLY FEEL VERY MUCH ILL-AT-EASE WITHOUT CENTRAL BANK CONSTANTLY IN EXCHANGE MARKET. MANY BUYERS AND SELLERS OF FOREIGN EXCHANGE ARE REMAINING OUT OF MARKET FOR AS LONG AS POSSIBLE IN HOPE THAT BOI WILL SOON RE-ENTER AND PROVIDE MORE CERTAINTY AS TO FUTURE EXCHANGE RATE. NEVERTHELESS, VOLUME OF TRADING HAS GRADUALLY INCREASED TO PERHAPS TWO-THIRDS OF NORMAL LEVEL. INITIALLY, PRESS HAS SPECULATED THAT BANK WOULD RE-ENTER MARKET THIS WEEK, BUT MORE RECENT COMMENTS HAVE SUGGESTED LONGER DELAY.

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ACTION EUR-12

INFO OCT-01 EA-07 ISO-00 EURE-00 ABF-01 FS-01 AID-05

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PA-01 AGR-05 /101 W

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P R 271500Z JAN 76

FM AMEMBASSY ROME

TO SECSTATE WASHDC PRIORITY 5364

INFO AMEMBASSY BERN

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PASS TREASURY AND FRB

7. EMBASSY IS INCLINED TO THINK THAT BOI WILL BE IN
NO HURRY TO RE-ENTER MARKET. IT WILL PROBABLY NOT DO
SO BEFORE AT LEAST INTERIM SOLUTION OF PRESENT POLITICAL
CRISIS HAS BEEN ACHIEVED. ALSO, WHEN BANK RE-ENTERS
MARKET IT WILL WANT TO BE ABLE TO DEMONSTRATE THAT
ITALIAN ECONOMIC AND FINANCIAL POLICIES ARE CONSISTENT
WITH STRENGTHENING OF BALANCE OF PAYMENTS POSITION AND
THAT BOI HAS SUFFICIENT FOREIGN EXCHANGE RESOURCES TO
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MAKE ITS RESUMPTION OF MARKET INTERVENTION CREDIBLE. BANK WILL, NO DOUBT, RESUME INTERVENTION ON RATHER SMALL SCALE SO AS NOT TO REVIVE PROSPECTS OF SUCCESSFUL ONE-WAY SPECULATION. AGREED-UPON ECONOMIC PROGRAM WILL HAVE TO INCLUDE FINANCIAL COMMITMENTS ENTERED INTO WITH IMP SIMILAR TO THOSE ALREADY REACHED WITH EC. IN ADDITION, LONGER-TERM PROBLEMS OF LARGE BUDGET DEFICITS AND CONTINUOUSLY HIGH RATES OF INCREASE IN LABOR COSTS SHOULD BE ADDRESSED IN SOME WAY.

8. TREASURY MINISTER COLOMBO HAS PUBLICLY REJECTED USE OF TIGHT CREDIT POLICY FOR FEAR OF NIPPING ECONOMIC RECOVERY IN THE BUD. HOWEVER, SOME MODEST MONETARY MEASURES, SUCH AS SMALL INCREASE IN RE-DISCOUNT RATE, MAY BE ADOPTED. (THREE-MONTH INTER-BANK RATE HAS ALREADY RISEN FROM 7.875 ON JANUARY 20 TO 8.50 ON JANUARY 26.) PRESS ALSO SPECULATES ABOUT SOME TAX MEASURES, PRESUMABLY INCREASE IN VALUE-ADDED TAX RATES ON SOLECTED PRODUCTS AND/OR IMPROVED COLLECTION PROCEDURES FOR VAT. ALTERNATIVE POLICIES OF TRADE RESTRICTIONS, RE-INTRODUCTION OF PRIOR IMPORT DEPOSITS OR ACROSS-THE-BOARD INCREASE IN BANK RESERVE REQUIREMENTS SEEM TO HAVE BEEN REJECTED. (SOME INDICATION OF GOI POLICY LINES WILL BE GIVEN BY TREASURY MINISTER COLOMBO ON JANUARY 28 WHEN HE REPORTS TO SENATE COMMITTEE ON LIRA CRISIS.)

9. FOREIGN BORROWING. AS TO NEGOTIATION OF FINANCIAL ASSISTANCE TO PERMIT RESUMPTION OF BOI EXCHANGE MARKET INTERVENTION, \$250 MILLION DRAWING ON \$3 BILLION NEW YORK FED SWAP HAS ALREADY BEEN RECEIVED AND ADDITIONAL \$250 MILLION IS CONTEMPLATED, LINKED WITH PROGRESS IN NEGOTIATING IMF STANDBY. SIMILARLY, PROSPECTS FOR ADDITIONAL \$500 MILLION BUNDESBANK GOLD LOAN APPEAR GOOD. THERE ARE ENCOURAGING SIGNS THAT NEW IMF STANDBY OF 450 MILLION SDR'S IS IN PROSPECT. FINALLY, EVENTUAL EC JOINT BORROWING ON EUROMARKET IS POSSIBLE.

10. EMBASSY BELIEVES THAT BANK OF ITALY WILL WISH TO BE ABLE TO ANNOUNCE FINANCIAL PACKAGE AT TIME OF RESUMPTION OF ITS INTERVENTION IN EXCHANGE MARKET.
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HOWEVER, ACCUMULATION OF FURTHER DEBT, AS ITALIAN PRESS HAS POINTED OUT, WOULD BE DOUBLE-EDGED SWORD. WHILE IT MIGHT BE HELPFUL PSYCOLOGOCALLY IN MAKING BOI

INTERVENTION CREDIBLE, IT WOULD ALSO ADD TO ITALY'S ALREADY LARGE FOREIGN DEBT OF ABOUT \$20 BILLION, OF WHICH MORE THAN \$13 BILLION HAS BEEN ACCUMULATED IN THE FORM OF COMPENSATORY BORROWINGS SINCE JUNE 1972.

11. EMBASSY ESTIMATES OF ITALIAN FOREIGN DEBTS AND ITS REPAYMENT SCHEDULE (BASED PARTLY ON DATA FROM BOI) SHOW ANNUAL INTEREST AND PRINCIPAL PAYMENTS ON BOTH COMPENSATORY AND NON-COMPENSATORY LOANS RANGING FROM \$3.4 TO \$4.6 BILLION PER YEAR OVER FOUR-YEAR PERIOD 1976-1979. THIS AMOUNTS TO AVERAGE \$4 BILLION PER YEAR. MEASURED AGAINST EMBASSY'S ESTIMATES OF GROSS RECEIPTS ON GOODS AND SERVICES IN 1976 OF ABOUT \$50 BILLION, AVERAGE DEBT BURDEN WOULD BE AROUND 8 PERCENT. WHILE THIS IS NOT A HIGH FIGURE BY LDC STANDARDS, IT IS HIGH FOR A DEVELOPED COUNTRY AND IS CERTAINLY HISTORICALLY HIGH FOR ITALY. FROM NOW ON ITALY'S FOREIGN EXCHANGE RATE POLICY MUST AIM AT EVENTUALLY REDUCING FOREIGN DEBT BURDEN. ON THE OTHER HAND, TO THE EXTENT THAT FOREIGN BORROWERS BECOME ACCUSTOMED TO IDEA THAT AN INDUSTRIAL COUNTRY SUCH AS ITALY CAN HAVE A CERTAIN AMOUNT OF FOREIGN DEBT OUTSTANDING, THEN REDUCTION IN SUCH DEBT NEED ONLY BE GRADUAL. SIMILARLY, DEGREE OF LIRA DEPRECIATION REQUIRED TO STRENGTHEN CURRENT ACCOUNT AS OFFSET TO REPAYMENTS ON FOREIGN DEBT CAN BE CORRESPONDINGLY LESS.VOLPE

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Message Attributes

Automatic Decaptioning: X
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: FINANCIAL CRISIS, FOREIGN EXCHANGE RATES, LIRA
Control Number: n/a
Copy: SINGLE
Draft Date: 27 JAN 1976
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: GolinoFR
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1976ROME01329
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: N/A
Errors: N/A
Film Number: D760031-0109
From: ROME
Handling Restrictions: n/a
Image Path:
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Legacy Key: link1976/newtext/t19760118/aaaaapai.tel
Line Count: 302
Locator: TEXT ON-LINE, ON MICROFILM
Office: ACTION EUR
Original Classification: LIMITED OFFICIAL USE
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 6
Previous Channel Indicators: n/a
Previous Classification: LIMITED OFFICIAL USE
Previous Handling Restrictions: n/a
Reference: n/a
Review Action: RELEASED, APPROVED
Review Authority: GolinoFR
Review Comment: n/a
Review Content Flags:
Review Date: 31 MAR 2004
Review Event:
Review Exemptions: n/a
Review History: RELEASED <31 MAR 2004 by KelleyW0>; APPROVED <31 MAR 2004 by GolinoFR>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
04 MAY 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: COMMENTARY ON LIRA EXCHANGE RATE CRISIS SUMMARY. AS OF JANUARY 26 LIRA EXCHANGE RATE HAD DEPRECIATED
TAGS: EFIN, IT
To: STATE
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 04 MAY 2006